Influence Strategies in Shareholder Engagement: A Case Study of Five Swedish National Pension Funds

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Abstract

Investors spend money and resources trying to reduce the environmental, social, and governance risks in companies they own. If unattended, these risks may cause reputational damage not only to the portfolio firm, but also to its owner. In this paper, we study five Swedish national pension funds and the influence strategies used in shareholder engagement. Knowledge about influence strategies is important because successful shareholder engagements can lead to more sustainable corporate behaviour and a lower risk to the investor. Our findings show that, besides traditional power and legitimacy dependencies which have been reported as influential in deciding stakeholder salience, we present five additional factors in determining influence strategies in shareholder engagement. We provide a conceptual model showing how these factors interlink with choices of influence strategies, offering a practical use of this study. Stakeholder theory has been used as our theoretical frame of reference, based on existing influence strategy literature taken from the stakeholder–firm perspective.

Keywords: case study, ESG directive, influence strategy, pension funds, reputation risk, responsible investment, shareholder engagement, shareholder salience, stakeholder theory

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1. Introduction

Pension funds have become significant owners of corporations. They are also institutions with a long-term commitment to pay out retirement benefits. Their long-standing investment horizon has increasingly made them consider long-term immaterial risks from environmental, social, and governance (ESG) factors in their investment decisions. It has become ever more important for institutional investors, like pension funds, to realize their options and act as responsible fiduciaries in both a legal and a practical sense (UNEP FI, 2009). In order to influence corporate decision making in a more responsible direction, pension funds use their ownership position alone or in collaboration with others (Clark and Hebb, 2004; Hebb, 2008).

What drives pension funds' shareholder engagement in firms? Pension funds have become increasingly large shareholders; their widespread investment in passive index funds has resulted in difficulties to withdraw from companies with poor ESG standards without experiencing short-term losses. When divestment in underperforming firms is not a financially attractive option, pension funds are better off engaging with firms and trying to influence behaviour in a more responsible direction (Clark, 2000; Hawley and Williams, 2000; Monks, 2001; Kim et al., 2009). This phenomenon referred to as the universal owner concept (Hawley and Williams, 2000) has become a fundamental change in mindset for some pension funds; the reality is that largely cognitive barriers are still preventing universal owners from exercising their power as responsible investors (Kiernan, 2007).

Furthermore, the understanding of existing engagement methods is somewhat clouded as the literature on engagement is divided into two main categories. On the one hand, the literature refers to *shareholder activism* to describe a conflict of interest between managers and shareholders (Gillian and Starks, 2000; Smith, 1996; Becht et al., 2009). This literature centres on traditional corporate governance activities, such as board composition and compensation issues (Gifford, 2009b). On the other hand, the literature refers to *shareholder engagement*, and then it also includes environmental and social drivers with an overall objective to steer portfolio firms towards more sustainable practices (Gifford, 2009b). Shareholder engagement, the term used in this paper, encompasses a range of investor activities, such as informal discussions with management and the voting of proxies, to more strategic approaches, such as launching a shareholder resolution campaign or the public exclusion of firms (Clark and Hebb, 2004).

Even though studies support the claim that a company's attention to ESG issues brings added financial value over the long term (Mercer, 2009), the literature also maintains that risk management is a potential driver for shareholder engagement (Gifford, 2009b; Clark and Hebb, 2004; Hebb, 2008). While pension funds try to increase control of social and environmental standards among portfolio firms, they not only respond to societal demands, but also attempt to mitigate the reputational risk of owning underperforming ESG portfolio firms (Clark and Hebb, 2004, 2005; Hebb, 2008). Attacks on brand images and corporate reputations combined with name-and-shame campaigns are common ways used by non-government organizations (NGOs) and other special interest groups to bring attention to corporate ESG violations (Rayner, 2003; Waygood, 2006). However, as the reputation of the portfolio firm is damaged, the shareholder's reputation is also negatively affected, resulting in a strong incentive for owners, like pension funds, to improve environmental and social standards at a portfolio-firm level to reduce the risk of damage to their own reputations.

Overall, the choice of engagement strategy needs to be considered against its related reputation and financial risks. The pension fund may, therefore, choose from a range of influence strategies to mitigate risk. In the area of influence strategies, Gifford (2009a) provides institutional investors with practical tools on how to deliver an effective shareholder engagement strategy, seeking to determine factors that contribute to shareholder salience. Little research has, however, focused on how shareholder influence strategies are decided and why (Gifford, 2009b; Sjöström, 2010), as the field is mainly practitioner-led (Gifford, 2009b). For instance, there is limited knowledge about how investors choose between shareholder engagement, exclusion, or other methods of changing corporate ESG behaviour relative to their portfolio firms, or about what influence strategies shareholders should consider when engaging with portfolio firms to ensure that the reputation risk to a portfolio is minimized.

In this paper, we look at influencing strategies within stakeholder theory (Frooman, 1999; Frooman & Murrell, 2005; Mattingly and Greening, 2002) to develop a framework for describing and analyzing the approach taken by pension funds to influence their portfolio firms. Specifically, the purpose of this paper is to describe how and why different influence strategies are used by pension funds in their interaction with portfolio firms. This study will explore underlying factors for the choice of influencing strategies stemming from reputation risk management and target audience analysis.

In order to develop a model of shareholders' influencing strategies, this paper presents the case studies of the efforts of five Swedish national pension funds (AP funds) to integrate ESG standards into the firms in which they invest. Unlike pension funds in many countries, the Swedish AP funds have since 2001 been governed by an explicit mandate to invest responsibly. Two different paths for how to influence portfolio firms emerged (Hamilton, 2009): one pension fund adopted an exclusion strategy; other pension funds advocated an engagement strategy. In analyzing the influence strategies used by the pension funds, we are able to develop research on influencing strategies by applying it to pension funds and identifying a set of influencing strategies which are closely entwined with the funds´ risk reputation management.

The paper is structured as follows. Next, we describe our theoretical frame of reference using stakeholder theory. In Section 3, research methodology is discussed followed by our research context and findings (Sections 4 & 5). In Section 6, we interpret our findings and construct a conceptual model. In Section 7, we discuss the implications for understanding shareholder influence strategies and their outcomes.

2. Theoretical framework

The government ESG directive guiding the AP funds was a timely response to societal expectations for corporate responsibility as supply chain issues in the apparel industry made headline news at the time of its formulation (Pettersson, 2010). The rise of globalization and increased societal awareness of the impact of business on communities and countries might have led to a revised understanding of business. The view of understanding corporations as the property of their owners with limited accountability for their externalities arose in a different era (Freeman et al., 2010). Stakeholder theory literature has developed over the last thirty years to provide a counter-view to seeing business as an instrument to maximize the owners' return. It argues that managers have obligations not only to shareholders, but also to a broader group of stakeholders. In his landmark work, Freeman (1984) focused on enabling managers to understand who their most important stakeholders are and set strategies for how to manage them.

Stakeholder theory assumes that organizations or firms are required to address stakeholder expectations and as part of the process of meeting these expectations, they may find themselves engaging with stakeholder groups. Consequently, stakeholder research has focused on who a firm's stakeholders are and what type of influence these stakeholders exert (McGee, 1998). Stakeholder management requires firms to understand the stakeholder influences and learn how to respond to them. However, even though stakeholder theory states that firms must pay attention to all constituents that can affect the value of the firm, there exists a value-maximization challenge since there is a trade-off between stakeholder demands to be managed (Jensen, 2002).

A basis for understanding the importance of a stakeholder influence is the well-known model by Mitchell, Agle, and Wood (1997), which focuses on stakeholder identification and why managers should pay attention to and prioritize certain stakeholders. They suggest that stakeholders become salient to managers through three attributes: the *power* to influence firms, the *legitimacy* of the stakeholder's relationship with the firm, and the *urgency* of the stakeholder's claim on the firm. The literature on stakeholder influencing strategies is largely based on Frooman's model (1999) of different stakeholder influence strategies which constitutes '*a significant contribution to stakeholder theory by modelling stakeholder influencing strategies to help management understand and manage stakeholder relation*' (Friedman and Miles, 2006: 110). Frooman (1999) adopts the perspective of the stakeholder instead of the more common management perspective of the firm (Hendry, 2005), and, similarly, our paper is concerned with how influencing strategies are used by pension funds targeting portfolio firms. Frooman (1999) introduces the idea that stakeholders can influence firms indirectly through the use of prevailing intermediaries. Frooman further argues that Mitchell et al. (1997) fail to show the relative strengths of their three attributes (power, legitimacy, and urgency) in their stakeholder salience model, and holds that power is the dominant attribute in determining the stakeholder–organization outcome (Freidman and Miles, 2006). Frooman (1999) combines resource dependency theory and stakeholder theory to explain determinants of how stakeholder influence strategies are used. He argues that a resource relationship exists between a firm and its stakeholders, and focuses on who is dependent on whom for resources (Pfeffer and Salancik, 1978).

In essence, '*the stakeholder can either be dependent on or not dependent on a firm, and a firm, in turn, can either be dependent or not dependent on the stakeholder*' (Frooman and Murell, 2003: 1).

A key contribution of focusing on influencing strategies is that it opens up a new understanding of a stakeholder as someone who is affected by the firm (financially or by reputation) and searches for effective methods to offset this dependence. Frooman's early work has been expanded upon (e.g. Hendry, 2005; Gifford, 2009; Mattingly and Greening, 2002) and such research has confirmed the merits of the Frooman model, but has also found it to be too simplistic to explain the variety of stakeholder–firm relationships encountered. Hendry (2005) arrives at an alternative model, adding factors, beyond power dependencies, to the influencing strategy selection. Hendry suggests that the communicative ability and the potential to actually form an alliance are important to consider.

In an application of stakeholder theory and influencing strategies to shareholder engagement, Gifford (2009a) offers a range of shareholder influence factors in improving the ESG performance of investee companies. Gifford also identifies moderating factors, such as coalition building, size, manager values, in addition to the legitimacy, power, and urgency of stakeholders (drawing upon Mitchell et al., 1997). Mattingly and Greening (2002) add explanatory power to the work of Frooman 1999 and Mitchell et al. (1997) and introduce a number of conditions that help explain stakeholder action between firms and public interest groups: (*a*) stakeholder culture, (*b*) a firm's response, (*c*) relationship with a firm, and (*d*) third-party relations. It appears Frooman's typology of stakeholder influence strategies is a useful starting point but depending on whether the research context is NGOs, shareholders, or some other stakeholder, we need to introduce underlying factors to fully be able to explain influence strategies between stakeholder–firm relationships. Based on the above studies, influencing strategy offers a promising framework to understand the interlinkage between an investor's choice between engagement and exclusion relative to the portfolio firm.

3. Research methods

This paper is based on a qualitative case study approach. The case study method was selected as it lends itself to capturing real-life contemporary phenomena and brings understanding to complex issues (Yin, 2003; Eisenhardt, 1989). Case studies, further, offer a systematic descriptive way of documenting a large number of events and analyzing actions taken by individuals or organizations, and the possibility to observe responses by and effects on other participants, which contributes to drawing an analytical conclusion (Hancock & Algozzine, 2006; Merriam, 1988). Such a contextualized and open approach was deemed necessary to explore the influencing strategies used by the AP funds and to arrive at an understanding of why they were used. We combined interviews and secondary data and a first interview round was conducted with five AP fund organizations (AP1–4 & AP7) between February 2007 and November 2007. The aim of this round was to study how AP funds interpreted the government directive and what type of influence strategies were used and why when the directive had been implemented. Twenty-three (23) interviews were conducted with individuals at different levels within the organizations and their boards: (*i*) the chairman of the board, (*ii*) the chief executive officer (CEO), (*iii*) the corporate governance officer, and (*iv*) the investment manager or the chief analyst. Each AP fund was approached via the corporate governance function acting as a liaison between the researcher and the respondents. Respondents holding these positions were selected as they are the responsible personnel actively involved in interpreting and implementing the ESG directive. The representatives from category 4 (investment manager or chief analyst) were decided by the AP funds themselves but all other respondents were requested by the first author. All interviews were semi-structured, conducted face to face, recorded, and lasted approximately one hour each. Findings that could be traced to an individual respondent are only disclosed if the information is already publicly available as all respondents were granted anonymity.

The second round of interviews with seventeen (17) respondents was conducted between January 2008 and April 2008. The decision to extend the interview material to also include key individuals representing external AP fund stakeholders was based on the opportunity to increase understanding while being able to cross-check and verify underlying influence strategies used by the AP funds. These AP fund stakeholders represent engagement consultants, rating agencies, institutional investors, portfolio firms, government, and academia. These respondents typically had a good working knowledge of different aspects of the AP funds' operations. Further, engagement consultants and rating agencies play an important role in the funds' engagement or divestment decisions as they supply the AP funds with ESG research data on portfolio firms. In Table 1, the total number of forty respondents from the two interview rounds is listed based on their type of position.

Table 1: List of respondents

Position	**Type of organization(s)**	**No. of respondents**
Chairman of the Board of Directors	AP1, 2, 4, & 7	4
Chief Executive Officer	AP1, 2, 3,4, & 7	5
Corporate Governance Officer	AP1[two], 2, 3, & 4[two]	6
Investment management	AP1, 2, 3, 4, & 7	5
Fund administration	AP3 [two] & 7	3
SRI consultant	SRI consulting firm	5
SRI analyst	Rating agency/Bank	5
Corporate Environmental (CSR) Manager	Portfolio firm	2
Owner representative	Government	2
Financial Manager	Institutional investor	1
Investment Manager	Fund company	1
Researcher	Academic	1

In addition, secondary data showing how the AP funds engaged with their investees and interacted with other stakeholders was collected from academic literature searches, news archives, AP fund annual reports, and AP fund websites. Due to the public nature of the AP funds, there is, in general, quite substantial media coverage and scrutiny concerning their activities, which facilitated the collection of relevant data from different points in time. Concerning AP 7, which employed the media as part of its overall influencing strategies, information was particularly plentiful.

The primary data analysis was performed in six steps following Creswell (2009). First, all interviews were transcribed. Second, all data was carefully read while thematic labels were written in the margin, indicating the length of the passage. In order to establish a more detailed analysis, a coding process was undertaken in the third step. The purpose of coding is to organize data into segments and similar topics were clustered together. Topics identified by a short description were entered into an Ms Excel sheet marked by pension fund and assigned by the exact quote. In step four, the Excel sort function proved useful as themes were analyzed for each individual case and between different cases in search of both commonality and differences. Through several iterative steps, we refined the themes by comparing them with each other, by searching for patterns between the themes, and by comparing with existing literature. In the fifth step, conceptual models were developed to depict a process for increased understanding (see Section 5). The final step involved making sense of the data, where Frooman's model (1999) and the extensions of this model provided a useful framework to offer meaning to the data.

Another reason for engaging in a second round of interviews was to validate the answers received from AP fund respondents. Further, data validity was ensured during a workshop for AP fund respondents where research findings were presented. The purpose of this activity was to validate research findings as well as introduce conceptual models to a practical audience. In addition, a strong reliance on maintaining orderly documentation, procedures, and a case study protocol (Yin, 2009) was used as a safeguard against some drawbacks of the case study method. First, it helped us to handle the large amounts of both primary and secondary data the method generates (Yin, 2003) and, second, it was used to reduce the risk of over-interpretation based on the researchers´ backgrounds (Creswell, 2009).

4. Research context—the 2001 Swedish pension scheme

In 2001, the Swedish pension system was reformed to be self-financing and completely independent of the national budget. Each month, Sweden's employers set aside 18.5% of their employees' pensionable income to the national pension system. This income pension system is referred to as a 'pay-as-you-go' system, which means that pension contributions paid every month are disbursed to cover current income pension benefits of those who have retired (SOU, 2008). The role of the First, Second, Third, and Fourth National Pension Funds (AP1, AP2, AP3, and AP4),[1] referred to as 'buffer funds', in the income pension system is to cushion temporary fluctuations in contributions and disbursements. The aim of these four AP funds is to maximize long-term return given a low risk level to benefit Sweden's pensioners (First National Pension Fund, 2008). The Seventh National Pension

[1] The smaller sixth AP fund, which invests in small and medium-sized unlisted companies, is also part of the buffer-fund system. There used to be a fifth AP fund, but it has ceased to exist.

Fund (AP7) is responsible for the premium pension system within the national pension. In this system, each individual is free to manage his or her future premium pension and can choose between a vast variety of mutual funds according to personal risk appetite. The mandate and investment guidelines of AP7, therefore, differ from those of the buffer funds. The same investment rules apply to AP7 as to private mutual fund providers competing in the management of pension premiums and their investments are completely dominated by shares.

The Swedish Government requires its national pension funds to consider ethics and the environment in the investment decision making. The Swedish guidelines, similar to those of the United Kingdom, emphasize disclosure on how responsible investment considerations actually are integrated into asset management practice. In the preparatory work (Government Bill, 2000: 2), one sentence summarizes the responsible investment mandate directing the five AP funds: '*Considerations shall be given to ethics and the environment without compromising the overall goal of attaining a high return*'. The provision regarding ESG considerations has not been included in the actual law, i.e. the Public Pension Funds Act (2000: 192). Surprising as it may be, it is not unusual for the Swedish judicial system to treat preambles as binding (Pettersson, 2010). There is nothing besides this guiding sentence that offers an additional explanation as to the meaning of ethics and the environment. The sentence is intriguing for AP funds as it challenges them to achieve two goals. Initially, some AP funds saw a tension between the goals, but less so over time as ESG understanding developed. As we will see, the interpretation of the sentence in the directive closely related to the choice of engagement strategy.

AP7 shares the same government undertakings regarding ethics and the environment as the other four AP funds, except that AP7 is prohibited from exercising its voting rights in respect of its Swedish shares. This mechanism was originally created to limit state influence on company ownership. In reality, this constraint has little practical use as the buffer funds, without any voting constraints, manage about ten times as much capital as the seventh AP fund (SOU, 2008). For a financial overview of the AP funds and the investment rules, see Appendices 1 and 2.

5. Research findings

In this section, we describe the AP funds' two main strategic approaches to influencing strategies as part of shareholder engagement.[2] On one hand, we have AP7 and the use of exclusion as the main strategy for responsible investment and to influence a more sustainable company behaviour. On the other hand, AP1, AP2, AP3, and AP4 have adopted an engagement strategy where engagement is focused on influencing companies to improve their ESG standards, mainly via dialogue and interaction. This section is organized so that we examine influence strategy 'AP Fund 7—Exclusion',

[2] These findings are based on interviews conducted during 2007. Much work involving the AP funds and shareholder engagement has developed since. This case study does not attempt to describe the AP funds' approach to shareholder engagement beyond this time.

and then we will study influence strategy 'AP Funds 1–4—Engagement' which was propagated by the four buffer funds. Each strategy is described and organized under four headings: (*a*) the management's background and attitude towards ESG, (*b*) policy formulation, (*c*) the influence strategy applied, and (*d*) ESG positioning. This section ends with a table summarizing some main differences in deciding factors leading to the two very different choices in influence strategy. The findings are supported with quotes from respondents working in the AP fund organizations and, in some cases, from respondents working as trustees or advisors.

<u>*AP Fund 7—Exclusion*</u>

The management's background and attitude towards ESG

The Seventh National Pension Fund started to operate on 1 January 2001, and it did not build on any preexisting organization. The CEO had experience of holding both government and private office, and was also familiar with ESG issues being the former CEO of a small financial services company specializing in ethical mutual funds. Unlike other CEOs in the AP fund system, the CEO of AP7 himself has the operational responsibility for the fund's ESG policy and implementation (AP fund chairman). The findings show that the CEO, the chairman, and the vice chairman all shared a personal interest in prioritizing and addressing ESG issues in parallel with developing an asset management organization in a short time. Prior to the AP7 launch, the CEO ordered a consultant with experience in politics and social affairs to conduct a benchmarking study on how to show consideration for ethics and the environment (AP Fund CEO). A working committee consisting of the CEO, the chairman, the vice chairman, and the consultant jointly interpreted the government directive and processed ideas into a workable ESG platform, which involved and was gradually presented to the rest of the board. As expressed by the ESG consultant:

> *[The CEO] took the [ESG] directive seriously. This surprised everyone. AP7 asked me to do a benchmarking study on what others had done. [The CEO] was very active in this work [ESG policy] but also some members of the board had prior experience of this area.*
>
> *(ESG consultant)*

In an early ESG policy draft, the idea was not to exclude entire controversial business sectors, such as alcohol, gambling, weapons, and tobacco, which otherwise is common practice in so-called negative screening of investment portfolios. The external consultant recommended a more stable platform to base the policy decision on. The basis of the policy was to be found in international conventions and UN principles that the Swedish Government had signed (AP fund chairman). There would have been a problem to exclude entire 'unethical business' sectors since the Swedish state at this time was a significant owner of companies producing or selling alcohol, gambling, and tobacco products (AP fund CEO). The board accepted these suggestions (AP fund chairman).

AP7 manages two funds in the premium pension system in competition with almost 800 private mutual funds. This may explain why the savings-customer perspective is predominant in research data from the AP7 organization. Examples of how the customer perspective is noted in interviews and the need to balance costs, profitability, and transparency follow:

> *If we do not show profitability, our savings customers will leave us.*
> *(AP fund CEO)*

> *The average savings customer in the PPM system [Premium Pension] saves for thirty-three years and, therefore, the cost must be very low.*
> *(AP fund chairman)*

> *You need to be able to communicate [your ESG policy]; you must explain your actions. Almost always when you start to work with ethical issues, there is a problem because it becomes difficult to explain.*
> *(ESG consultant)*

To develop an ESG policy that was easy to understand and possible to explain to customers appears crucial for the working committee and the board of directors. It is likely that this process was influenced by the prior experience the consultant had with supporting leading politicians in managing ethical and moral transgressions which at times ended up in the press. His experience with reputation risk management was useful as portfolio companies risk being caught in ESG dilemmas. Finally, AP7 respondents emphasize its small organization and core philosophy to outsource most of its investment management needs and negotiate external fees and costs to the limit (AP fund CEO and AP fund chairman).

Policy formulation

Only AP7 met the government deadline of having a public policy online addressing the ESG directive on 1 January 2001 (AP fund CEO). In the AP fund system, the board of directors is responsible for the fund's ESG policy. The board decided that the fund only shall invest in companies that comply in an acceptable way with the requirements of international conventions that Sweden has signed. In application of the policy, AP7 'only uses the exit method' (Seventh National Pension Fund, 2010a). A norm-based screening method is applied to monitor corporate activity that violates or threatens to violate global standards on environmental protection, human rights, labour standards, and anti-corruption as stated in a large number of international initiatives and guidelines (Ethix SRI Advisors, 2010). To assist AP7 in determining whether a company has violated an international convention, services that screen portfolio holdings are purchased from two separate screening and rating agencies. Unlike the buffer funds, AP7 purchases this service from two separate suppliers to ensure maintained quality. At one point in time, only one service provider was left on the Swedish market. AP7 reacted against a monopolistic market situation and bought a 5% ownership stake in the other Swedish rating agency to maintain a competitive market situation (AP fund CEO). As we can see, becoming an part-owner of a rating agency is not an uncontroversial issue for an AP fund:

> *[The CEO] wanted to create competition among rating agencies. He feels GES [rating agency] has improved because Ethix [rating agency] is on the market. This caused a big discussion among the board*

members as to whether it is the role of an AP fund to own a rating agency.
(AP fund chairman)

Despite the notion of modern portfolio theory that restrictions reducing the investment universe will increase portfolio risk, AP7 believed it could compensate for exclusions without compromising the overarching government objective of attaining a high return. As long as the AP7 'blacklist' consists of no more than thirty companies, the board believes that this may not challenge the main objective (AP fund CEO). They were trying to create a 'black-and-white' system:

I believe our model [exclusion] is easier to implement because there are very few cases that fall into a grey zone.

(AP fund chairman)

A company that has violated any global agreement signed by the Swedish Government and is convicted will eventually be sold according to the policy of AP7. The company will be suspended for five years, but sanctions can be lifted if the company's improvement is documented and backed by a trustworthy source. Once sanctions are lifted, it is possible for AP7 to reinvest in the company. The important distinction, compared to other AP funds, is that no engagement efforts are made prior to divestment. Many non-AP7 respondents believe that the rule forbidding AP7 to vote in Swedish companies was a contributing factor for not using engagement as a strategy. If the law forbids you to use your ownership rights to vote, you are automatically prevented from using engagement as a model of influence. This restriction does not, however, apply to ownership in foreign companies. Nevertheless, AP7 justifies its decision to use exclusion combined with negative publicity as the preferred way to influence companies to adopt more sustainable practices. According to the CEO of AP7, engagement as an influence strategy does not provide a clear model and is, therefore, not viewed as an alternative for AP7. Finally, the AP7 CEO denies that this legal restriction has influenced their choice of method in applying the ESG directive:

Our exit strategy has nothing to do with the fact that we are not allowed to vote in Swedish companies.
(AP fund CEO)

The influence strategy applied

In spring 2001, the first screening report was delivered. Esselte, a Swedish office supplies company, was caught in the screening. Apparently, one of its subsidiaries in Mexico was forcing its female employees to take pregnancy tests each month. Those who were found to be pregnant would be fired. This appeared to be a clear human rights violation. As a consequence, AP7 sold Esselte's shares and the company was placed on the 'blacklist'. The media got hold of the story and the Esselte management, after checking the story, admitted it was true, and that it would immediately put a stop to this type of discrimination (AP fund CEO). This is the normal exclusion procedure for how both Swedish and foreign shares are processed. Besides this case, very few exclusions have involved Swedish companies. The CEO is satisfied with the procedures and, in particular, the profile it has given AP7:

> *It [exclusion strategy] has served us well. We have been recognized for a fairly aggressive ethical policy that the public understands. We have set a standard.*
>
> *(AP fund CEO)*

More specifically, screening reports are received twice a year from both suppliers. The screening and rating agency handles the communication with the company and the critical verification of the supposed violation. AP7 annually issues a list of excluded companies which over time has contained between twenty-five and fifty-five companies.

As described, the principal objective in the ESG directive is to secure a high return for a low risk for the pension savers in the premium pension system. But how does AP7 control for this? For example, by avoiding excluding entire industry sectors diversification can be maintained. In 2005, AP7 retrospectively checked (five years) what would have been the performance result if no exclusions had been made at all. The performance between the screened and a hypothetical unscreened portfolio were the same, with a slightly higher risk in the screened portfolio (SOU, 2008).

ESG positioning

In our case material, we can observe that the exclusion strategy is also supported by AP7's strong ESG profile. From a marketing perspective, synergies with the media and a publicity-driven exclusion strategy are created. With leadership experience from an investment firm specializing in ethical funds, it appears the AP7 CEO wanted to market the fund as a responsible investor. This first-mover advantage to fill an ethical leadership position among AP funds appears well thought out and value adding as it is embedded in annual reports and other important stakeholder communication vehicles:

> *We wanted to be seen as a private fund company competing with 700 competitors. We do not want too much to be associated with the buffer funds.*
>
> *(AP fund CEO)*

We can assume that an ESG position on the premium pension market was useful in attracting and maintaining savings customers. Thus, it appears AP7 has chosen and maintained a strong ESG profile and is generally satisfied with the strategy:

> *We, the board, have said many times that it is very good that we have created this profile and we will continue doing so.*
>
> *(AP fund chairman)*

AP7 has received much ESG publicity as ESG operational responsibility lies with the CEO and because an AP fund CEO is considered a credible spokesperson for financial issues in Sweden. There are examples in the case material of how AP7 quite strategically uses the media to reveal its ESG position (the use of an external spokesperson on sustainable development and awarding an annual journalism prize). Not surprisingly, and in contrast to the buffer funds, AP7 uses traditional consumer marketing tactics like any other ethical mutual fund on the premium pension market.

AP Funds 1–4: Engagement

The management's background and attitude towards ESG

Unlike AP7, three out of four buffer funds had existing organizations from the old pension system to rely on. One fund had experience of managing both Swedish and foreign equity (AP4), one fund had limited Swedish equity experience (AP3), one fund had only managed fixed income (AP1), and one fund, like AP7, was a newly established organization (AP2). Thus, the background and asset management experience among the buffer funds differed. As of 1 January 2001, they all shared identical investment guidelines and a capital base of $19 billion. These organizations were all larger than AP7 with more internal fund management capacity. During the start-up phase, respondents representing the buffer funds recall that addressing the ESG directive was not among the most critical issues as there were several other pressing matters to address. Most notably, the need to establish an investment organization took priority (AP fund corporate governance).

Since AP7 was the first of the AP funds to publicly disclose its ESG policy, most respondents from AP Funds 1–4 refer to AP7's work. Some buffer funds also contacted AP7 for individual discussions and exchanging experiences:

> *We looked at AP7. It was faster than us in formulating so that we should follow international conventions, and during our discussions it became clear that this is how it should be handled. (AP fund CEO)*

Some buffer funds also used consultants to help them interpret the directive. AP2 studied the British asset manager Hermes' approach to managing corporate governance issues (AP fund corporate governance). The purpose of having four buffer funds instead of one was to create competition between funds, which then would hopefully lead to better performance. Initially, this prompted buffer funds to try and come up with their own ESG model, several respondents declared.

Like AP7, all buffer funds adopted the norm-based screening method that is founded on international conventions signed by the Swedish Government. But the AP7 exclusion strategy was not adopted. Our findings suggest this method was not an attractive solution for the buffer funds. Why? The initial attitude towards the ESG directive among investment managers of AP Funds 1–4 appeared somewhat sceptical. The ESG directive was initially perceived as a restriction by AP fund investment managers (AP fund corporate governance). The AP7 exclusion method would have imposed and reduced the investment universe:

> *Some investment managers were very reserved about the ESG directive. They felt it to be a political mandate. All restrictions are negative and during this time we had an aggressive compensation structure based on performance.*
>
> *(AP fund corporate governance)*

> *When we decided to screen our portfolio, we were not convinced [about engagement], but when we received the first report [screening], 10 per cent [or forty-five companies] of portfolio value would disappear if we excluded.*
>
> *(AP fund corporate governance)*

In the study, the choice of influence strategy in buffer funds rests on two assumptions. First, exclusion would reduce the investment universe and potentially harm the principal objective to attain a high return, as described above. Secondly, from an influence point of view, engagement was believed to be the best method for achieving a real influence on corporate behaviour:

> *Many in the organization were involved in looking at how this would affect performance and risk if we were to exclude. We thought that engagement [as an alternative to exclusion] would not affect performance negatively.*
>
> *(AP fund corporate governance)*

Thus, all buffer funds ended up using engagement as a primary method to influence portfolio companies to reduce sustainable risk, even though ambition and time devoted to these issues varied among buffer funds. For instance, AP1 took a lead in engagement practice towards foreign company holdings (AP fund corporate governance). Prior to 2007, little was communicated between the four buffer funds or externally regarding the engagement method or results. Indeed, engagement is traditionally viewed as a practice performed in secret with the portfolio firm and not to be disclosed to anyone outside this process and especially not the media (AP fund corporate governance).

As with implementing the ESG directive, buffer funds learn that it is very difficult to apply the directive without involving and having investment managers supporting the idea (AP fund CEO). Within buffer funds, the ESG responsibility is executed by the corporate governance officer. This individual also handles corporate communication responsibilities in all four respective funds. All buffer fund CEOs appear serious regarding the importance of the directive and in all cases clearly express their full support for the corporate governance member in charge of implementing the directive.

Policy formulation

The completion of an owner policy, addressing the ESG consideration, and formulating an engagement strategy were activities that varied among buffer funds. Some funds worked more closely with a rating agency and this appears to have generated more momentum and resources for completing an internal ESG process. An outside screening provider would deliver a report twice a year, filtering the complete portfolio, typically 3,000–3,500 companies, for ESG violations. Approximately 100 companies are typically singled out based on media, NGO, and UN reports. A final list of ten to twenty-five potential companies with well-documented violations is then provided. Determining the final selection of engagement candidates is what industry the targeted company is operating in, from where the company originates, and what international convention or policy the accused company is violating (AP fund corporate governance). It appears AP1, together with GES Investment Services, developed the engagement model that later became the standard for all buffer funds to use (AP fund corporate governance):

> *AP1 devoted the most time to ESG. They took the lead and it was AP1's engagement work that created a model for the Ethical Council.*
>
> *(AP fund corporate governance)*

In 2007, the decision was taken by all buffer funds to collaborate on all foreign engagements and form the *Ethical Council*. The council consists of one member from each buffer fund, usually the individual staff member who is responsible for the ESG directive. Each buffer fund makes its own decision, for instance, on an exclusion based on the recommendation of the council. The buffer funds annually rotate the presidency of the Ethical Council. Increased engagement power with a larger combined asset size to a reduced cost were the main drivers supporting collaboration (AP fund corporate governance). It appeared a logical decision that all respondents favoured.

On the other hand, most buffer funds feel that engaging with Swedish companies is less demanding because an AP fund is usually a prioritized shareholder and access to a company's management is fairly easy (AP fund corporate governance and AP fund CEO). Reputation risk is generally also lower among Swedish portfolio firms (AP fund CEO). But in engagement with foreign companies, AP funds are typically relatively small owners and they are usually unknown to the companies they approach (AP fund corporate governance). Compared to exclusion, engagement is more costly and time consuming. No buffer fund is, however, able to specify how much resources ought to be spent on engagement. It appears based more on gut feeling and what is accomplished today given the available resources:

> *It is a balance. It is difficult to decide how much resources to dedicate. One has to balance high performance and low risk with the cost for ESG given the capital you have and how strong an owner you are.*
>
> *(AP fund CEO)*

Further, following the creation of the Ethical Council, more resources were purchased from the service provider GES Investment Services. Board involvement in ESG issues is strong and committed, most buffer fund respondents declare. However, it is unclear whether buffer funds' trustees were as active during the actual interpretation and policy development phase as in the case of AP7. The board is said to be concerned about and interested in how the ESG work is progressing (AP fund corporate governance). Finally, the board is responsible for the policy that governs the fund, but, like managing funds, they shall not be involved in operational aspects (AP fund CEO).

> *We have ESG as a separate issue during board meetings. We always have a briefing note, but it might not have been sent out prior to the meeting.*
>
> *(AP fund chairman)*

The influence strategy applied

In 1999, a man was convicted in Costa Rica of pimping minors at one of the hotel chain Marriott's hotels. The hotel staff failed to report this. In 2003, AP1 became aware of the incident through screening by GES Investment Services. Between 2003 and 2005, a number of letters were sent to Marriot with the objective to hear the company's account of the incident and to start a dialogue. AP1 received no response. In October 2005, a resolution was filed with the help of ICCR (Interfaith Center of Corporate Responsibility). Marriot reacted in late 2006 and the hotel chain adopted a new human rights policy that explicitly addressed child sex tourism. The investor coalition withdrew the resolution once Marriott promised to address the problem and agreed to engage (First National Pension Fund, 2007). This example shows that engagement takes time and that external coalitions can be a useful solution to ending the process:

> *It [the engagement] involved a lot of work and follow up over years, especially for an unknown Swedish pension fund. We also owned very little. At the beginning, there was only us. Then we allied with ICCR to form a coalition.*
>
> *(AP fund corporate governance)*

There are engagement cases where portfolio firms never respond. If there is still no response from the portfolio firm in spite of several attempts to engage with the company, the final option is to exclude the firm. Compared to AP7, the exclusion list made by buffer funds was for the first couple of years quite limited. However, the number of exclusions has increased with the establishment of the Ethical Council. The attitude shared by all buffer funds is that engagement is a superior way to influence companies over time and in close cooperation with the companies:

> *I do not see the effectiveness in the dialogue if you [the investor] start to threaten to sell. Better, instead, to push the company for a reaction. "We believe you [the company] should look this over. You will be questioned by others.*
>
> *(AP fund corporate governance)*

The advantages of this influence strategy are that the AP fund system has a large capital base and that it is credible as a national pension fund (AP fund corporate governance). Further, the buffer funds' engagement strategy is founded on the notion that dialogues should not be conducted through the media. Buffer funds believe confidentiality brings value in the long-term process, and cooperation is better than being discredited in the press (AP fund corporate governance). Another way to influence as an owner is through resolutions at companies' annual general meetings; AP3 has been an active co-filer in 300 companies in its foreign equity portfolio for 2009. Most of these portfolios are managed by external fund managers, to whom voting rights or so-called proxy votes are given (Third National Pension Fund, 2009).

ESG positioning

In comparison with AP7's ESG profile, the buffer funds' relationship with the media has been more complicated. The study shows that buffer funds feel that reporting on engagement should not be communicated, especially not during its active phase. Respondents state that portfolio firms are reluctant to discuss their ESG performance because they fear the media and the risk of negative publicity. To some extent, this notion might also appear true for the buffer funds themselves and their relationship with the media. In the period following the introduction of the ESG directive, they did not have very much to report as ESG activity was developing. However, our findings suggest a change in attitude might be taking place as they appear more confident since they have joined forces in the Ethical Council:

> *Companies are terrified to talk about ESG performance since they are afraid the media will pick up the story. I mean, just look at us. This is the first year [2007] we are writing about it [an engagement case]. Now we are capable; we have the experience and confidence. We have the platform to stand on.*
> *(AP fund corporate governance)*

All buffer-fund respondents are sceptical of the media. The opinion appears to be that the media is unreliable and it will probably create an unfavourable angle on the story which will, most likely, create negative publicity for the fund (AP fund CEO, AP fund corporate governance, and AP fund chairman). A key issue for the buffer funds is that they do not discuss the engagement activities and they rarely exclude companies. This combination makes it difficult for the buffer funds to communicate their activities to the media in a simple and credible way and, at the same time, provide the media with a newsworthy story:

> *The Swedish media has become very much fixated with the fact that you exclude companies. It becomes an interesting news story and it is turned into black and white. We have experienced that it is very difficult to communicate the other way of working [engagement] as there is little media interest and attention . . . AP7 has formulated a strategy and it receives attention for it.*
> *(AP fund CEO)*

Some buffer-fund respondents feel that there is a risk attached to maintaining a high ESG position as you are measured according to different standards (AP CEO and AP fund corporate governance). Partly, this was the reason why the buffer funds sought a less public ESG profile.

> *[We felt the AP7 CEO] is not in the business of creating value, rather in the business of determining what is right and what is wrong and making himself a judge of what is black and white. To say that you are more ethical than others is absolutely the most dangerous thing to do. Because there are many that would like to see you come a cropper.*
> *(AP fund corporate governance)*

Unlike AP7, the customer perspective is totally different for the buffer funds. Their customers or beneficiaries are captive in the sense that they are prohibited from withdrawing or moving their money out of the pension system. For this reason, beneficiaries become a less interesting audience to try to attract and interact with as compared with the type of savings customer AP7 has.

Even though it has been stated that buffer funds collectively maintain a low ESG profile, AP2 is the exception and has made efforts to communicate its ESG view and activity level (Second National Pension Fund, 2007).[3]

A summary of factors behind the choice of influence strategy

In Table 2, we summarize the main differences between the influence strategies used by AP 7 and AP1–4. The left column shows the key factors behind the choice of influence strategy. The first factor is the *management's ESG experience and attitude*. Another is the *interpretation of the directive*; depending on how the main objective of attaining a high return is understood, either exclusion or engagement may be preferred. Another important factor is the existence of *dependencies*, either in terms of power or legitimacy. *Power dependencies* arise from the strength of the link between the fund and the portfolio firm and the focus on the direct influence on behaviour in the relationship between these two actors: an AP fund, known by the portfolio firm, with a long-term investment horizon, and a large ownership, can more effectively influence firms and their ESG behaviour. *Legitimacy dependencies*, instead, concern influence deriving from the credibility of the fund: a national pension fund as a long-term investor, with large capital assets, and with a good market reputation is highly influential in terms of financial commentaries made and investment activities performed. Legitimate claims made by AP funds may influence or guide portfolio firms' ESG behaviour. This is especially true when the engaged firm is Swedish.

Further, *reputation risk* is an important factor, showing the risk for the fund in choosing a certain strategy. For example, a portfolio firm, with underperforming ESG standards, or, even worse, convicted of breaching international ESG principles, may damage its reputation and brand name. Indirectly, this risk can also affect its shareholders and more so if the investors are known and legitimate. Therefore, it becomes an important factor for AP funds to become transparent and show the media, their customers, the portfolio firms, and other important stakeholders exactly what actions they (the AP funds) take to influence the behaviour of a portfolio firm to minimize reputation risk. The chosen influence strategy must be easily communicated and understood so that the AP funds can be measured on their mitigation activities regarding reputational risk. Consequently, another important factor behind the choice of influencing strategy for the Swedish context is the *target audience.* By target audience, we mean the formal or informal recipients which the AP funds' influence strategy outcomes are aimed at. What audiences is a specific AP fund seeking to influence or to be considered credible and responsible by?

[3] AP2 not only addresses the risk aspect of ESG considerations, it also focuses on ESG as a value-added investment opportunity. This notion is important but will not be further addressed in this paper.

The following factors do not justify the type of influence strategy to choose but can, instead, be considered as a supporting factor decided by the influence strategy: *a third-party intermediate* and *ESG positioning*. The former may help leverage an AP fund's influence strategy when a portfolio firm is not dependent on an AP fund and a coalition may add pressure to the engagement process, or in the case of the media when used to ban a portfolio firm and communicate an exclusion. Finally, the AP fund's ESG positioning can be a supporting factor when using an influence strategy. A strong ESG position requires a clear and transparent system allowing little room for interpretation of the selected strategy. A less outspoken ESG position is better to combine with an influence strategy that is less transparent and more difficult to communicate to the stakeholders concerned.

Table 2: Factors determining influence strategies

Factors determining influence strategies	**AP7: Exclusion strategy**	**AP1–4: Engagement strategy**
Management's ESG experience and attitude	- The CEO, the chairman, and the vice chairman shared an ESG interest and commitment, and they had some practice. - The CEO maintains operational responsibility for ESG issues. - They prioritized the ESG and met the government deadline to formulate an ESG policy on time.	- There was little practical ESG experience following the 2001 pension launch. - A corporate governance officer is responsible for ESG issues. - The ESG directive was not considered among the most pressing issues during the pension launch.
Interpretation of the directive	- Exclusions can be controlled for without compromising the directive's objective of a high return and a low risk.	- An exclusion strategy is less attractive as it may interfere with the directive's main objective of obtaining a high return. - Engagement is the preferred model to influence portfolio firms to improve their ESG standards.
Dependencies *(Power & Legitimacy)*	- AP7 relies less on power as there is little prior relationship between the pension fund and the portfolio firm. - AP7's legitimacy is more important as exclusions create negative publicity, which aims to improve underperforming corporate ESG behaviour.	- A joint collaboration in the *Ethical Council* may result in stronger power and legitimacy dependencies in engagements with foreign portfolio companies. - An investor coalition can add power and legitimacy as the *Ethical Council*'s engagement alone may result in little effect.
Reputation risk	- A transparent exclusion strategy is easier to communicate and to be conceived and preferred in managing reputational risk. - The media is a crucial ally and a conveyor of reputation risk used to (*i*) communicate the exclusion of the firm, (*ii*) signal the fund's high ESG profile to customers, and (*iii*) lend legitimacy and power to the fund.	- An engagement strategy is more difficult to explain to stakeholders, especially if conducted in secret with portfolio firms. - Mainly prior to 2007, there was a lack of transparency towards the media and other stakeholders regarding engagements, which, consequently, increased the overall reputation risk.

Target audience(s)	- (1) Portfolio firms are influenced to improve their ESG performance, which reduces reputation risk and increases investability. - (2) Savings customers are important to influence and retain as they are free to move their savings money in the premium pension system.	- Portfolio firms are influenced to produce stronger ESG performances, which then results in reduced reputation risk for both the investee and investor.
Factors supporting influence strategies		
Third-party intermediary	- The media is used as an amplifier and broadcaster of negative publicity to increase pressure on the portfolio firm.	- Coalitions are formed with other investors, resulting in additional engagement leverage.
ESG positioning	- Being recognized as a responsible investor in the marketability of AP7 to attract and maintain savings customers is an attractive position.	- It is less important for the buffer funds to seek an ESG leadership position as their engagement model is initially performed in private.

6. Discussion

In this section, we will discuss the factors behind the choice of influence strategy and present a conceptual model explaining how these underlying factors link with each other and the choice of strategy. Then, we end Section 6 by presenting a two-by-two matrix where we link theoretical implications with our empirical findings on influence.

Factors determining influence strategies

Our findings indicate that, apart from dependencies (power and legitimacy) which have already been reported in the literature (e.g. Frooman, 1999; Gifford, 2009) as influential in deciding stakeholder salience, we can add four additional factors in determining influence strategies in shareholder engagement: the *management's ESG experience and attitude, the interpretation of the directive, the reputation risk, and the target audience* (see Figure 1).

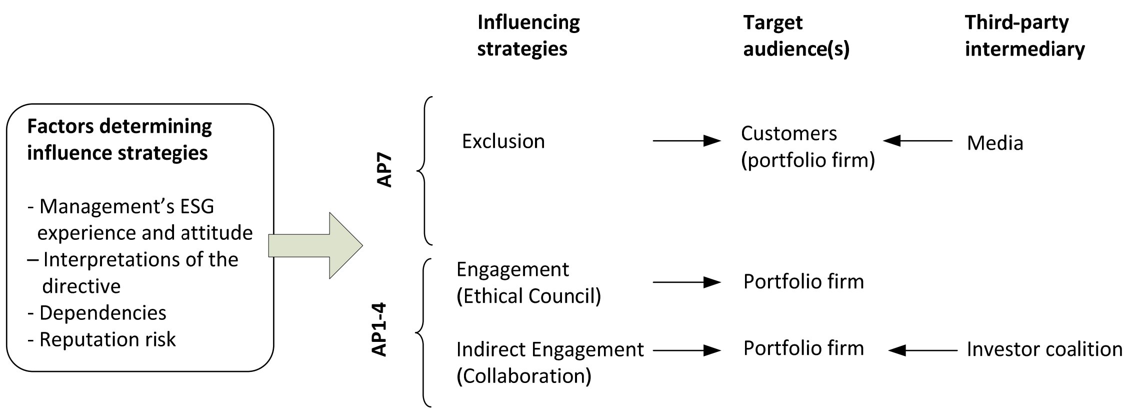

Figure 1: Factors determining influence strategies

Power dependencies have been described from the perspective of the relationship as well as characterizing the actor (Mattingly and Greening, 2002). In our findings, we see mainly the lack of an AP fund 'relationship' or 'actor' power vis-à-vis foreign portfolio firms, which is also confirmed by Hebb (2008) in her study on pension funds and corporate engagement. In general, all AP funds own shares in some 3,000+ global companies. Their ownership is small and there is seldom a relationship between AP funds and portfolio firms. The situation is totally the opposite for Swedish portfolio firms where each AP fund's own engagement (or exclusion) is based on an existing ongoing relationship and power dependencies, as described by Mitchell et al. (1997). Therefore, a lack of power dependency can be compensated for by seeking *third-party intermediaries* (a supporting factor) to strengthen the missing dependency. To develop influence strategies, both AP7 and the buffer funds turn to different outside allies (the media and investor coalitions). The reason why AP7 does not primarily seek allies from the institutional investor community is because its exclusion strategy is still effective when performed individually. AP7 complements its strategy with negative publicity which is increased and spread through the mass media.

Another determining factor is the *interpretation of the directive*, limiting and guiding the behaviour of the AP funds. Even though the same sentence in the directive applies to all AP funds, it was interpreted differently by them. Maybe, this was also the government's intention since it created a system of multiple AP funds to compete, thus allowing a diversity of approaches. We know from the study that AP7 believes that exclusions can be controlled for given a relatively small number of firms (<30) are excluded. But we are uncertain whether it is the buffer funds' ideology, or if it is the threat of violating the main objective of the directive (high return), that guides their choice of influence strategy. It may be that the initial concern of the buffer funds' investment managers about applied restrictions on the investment universe had a strong impact and, hence, the reason for engagement as the 'preferred' model is merely a more publicly acceptable explanation.

Furthermore, a set of *reputation risk* factors combine with other factors in shaping the influence strategies. Our study reveals that the ESG directive can help AP funds reduce their reputation risk by monitoring their ESG risk on a global portfolio basis. The ESG policy formulation among all studied AP funds is chiefly created to address the risk aspect of ESG rather than focusing on ESG as an added-value opportunity. Reputation risk reduction appears a strong determining factor for AP funds as they choose the type of influence strategy. This is a factor that was not mentioned in the models of Frooman (1999), Hendry (2005), and Mattingly and Greening (2002). It is somewhat surprising since damage to a brand image can be the outcome of stakeholder–firm campaigning. However, it is confirmed by Hebb (2008: 59), who states that 'the link between corporate reputations and long-term value is increasingly evident for large institutional shareholders. It is this link that plays a fundamental role in why pension fund investors care about the standards and reputations of the firms in which they invest'. In this paper, we argue that AP7's exclusion strategy mitigates this risk more effectively than that of the buffer funds, mainly because AP7's strategy ends (divestment) any association with the firm.

An additional important factor is the influence strategy's intended *target audience*. Obviously, the portfolio firm is the target in a shareholder engagement model based on dialogue and conducted in private, as has been reported by the buffer funds. However, it becomes more complicated in the case of AP7. Hence, AP7 considers its influence strategy as a way to enhance its reputation as a responsible investor and seek an ESG leadership position by targeting primarily their customers who, in essence, are all Swedish citizens. Therefore, our model consists of an audience factor and we believe the portfolio firm that AP7 seeks to influence appears more as a secondary target. We argue that its non-interactive influence strategy distances it from the portfolio firm which is probably not its main audience. It is likely AP7's main concern and influence target are its savings customers, instead. The criticism that ethical mutual funds are better at communicating a strong ESG commitment than actually showing it in practice has been reported in several studies (see Frankental, 2006; Haigh and Hazelton, 2004). However, we are not implying that the AP7 *management's ESG experience and attitude* are not sincere or inferior to the other AP funds. But its choice of ESG communication strategy resembles that of some criticized ethical mutual funds. Or, as expressed by one respondent: when you start to imply superiority in ethical and environment considerations, you automatically increase your reputation risk and attract the media's attention.

A model of the AP funds' influence strategies

Finally, we develop a model of the AP funds' influence strategies in shareholder engagement with foreign portfolio companies based on our findings and drawing upon factors found important for influencing strategies in existing stakeholder literature. The underlying framework rests on the work of Frooman (1999) and Mattingly and Greening (2002) describing stakeholders' influence strategies as a function of the power–dependence relationship between firm–stakeholder groups. The models of Frooman (1999) and Mattingly and Greening (2002) are especially useful for understanding what determines interaction between a firm and its stakeholders and the use of influence strategies. With this model, we are able to map four different influence strategies seen in the AP fund case studies.

The model's two dimensions are the *pathway of influence,* whether direct or indirect (see Mattingly and Greening, 2002; Frooman, 1999), and the *level of interaction*, whether high or low (see Figure 2). Direct paths of influence mean that the AP funds may interact (or choose not to interact) with the portfolio firm directly and put forward its claim as opposed to an indirect approach where the AP funds may opt to go through a third-party intermediary to influence the firm. In this context, direct refers to the pension fund–firm relationship regardless the outcome (dialogue or not). The level of interaction between the AP fund and the portfolio firm can range from high (dialogue) to low (little or no dialogue). When combined, the two dimensions distinguish between two direct influence strategies identified in our findings, i.e. *engagement* and *exclusion*, and two indirect strategies, namely *investor coalition* and *proxy voting* (external voting body).

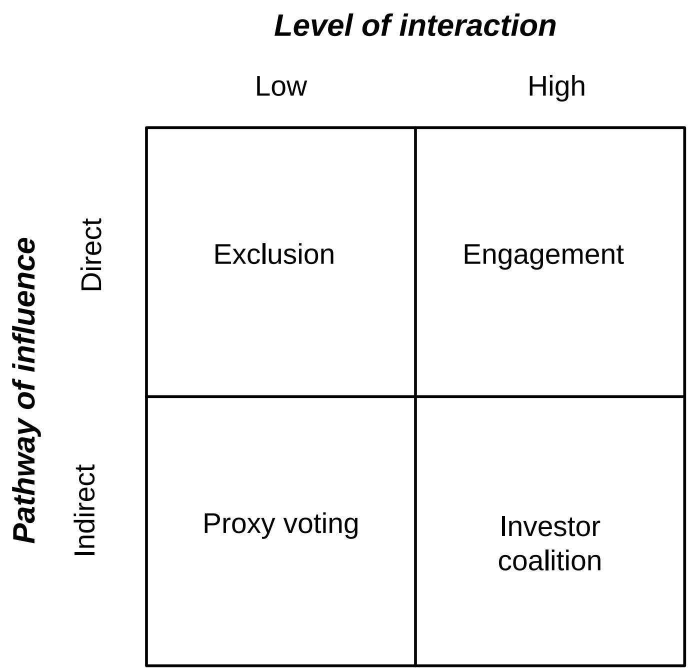

Figure 2: A model of the AP funds' influence strategies (adapted from Mattingly & Greening, 2002)

- **Engagement**: The engagement work of the buffer funds is conducted in mutual confidence with the portfolio company. Both parties cooperate and try to reach the common objective of minimizing reputation risk. This reputation risk is ultimately shared by the pension fund until fully mitigated by the portfolio firm. The asset owner and the firm negotiate to reach a solution to the ESG issue that both parties can benefit from.
- **Investor coalition**: Since 2007, the buffer funds have jointly engaged foreign portfolio firms through the Ethical Council. In situations where the Ethical Council lacks recognition and influential power, it may be more effective to collaborate with a third-party investor. For asset owners, like the buffer funds, who have often lacked both power and legitimacy in influencing foreign portfolio firms, an investor coalition can gain political power by joining forces with large geographically better-placed investors which the portfolio firm is dependent on. In the future, we predict investor services, like the UN PRI Clearing House, will be even more important as institutional investors need to combine direct and indirect influence strategies.
- **Exclusion**: This represents the influence strategy chosen by AP7. Its integration approach is low or non-existent. AP7 does not seek a cooperative approach with the portfolio firm. It believes divestment is the preferred method to influence corporate ESG behaviour. At the end of the ban period, the firms have to prove that they have taken corrective measures for their past ESG inaction and then they become investable again.
- **Proxy voting**: This is a low interactive influence strategy where the shareholder has the formal right to submit concerns about how a firm's ESG risks are handled. The influence strategy is indirect since the asset owner assigns the voting right to an external third-party voting body. Shareholder resolutions can be filed directly but, for practical reasons, they are mainly managed and executed indirectly through a clearing house (proxy voting).

7. Conclusion

In our endeavour to extend the work on influence strategies in shareholder engagement to pension funds, we have come across several factors linked to the investors' final choice of strategy. In our case study findings on the Swedish AP funds, we discovered that reputation risk is a strong motivation for engaging with portfolio firms and that the target audience is another important factor in determining influence strategy. Since the premium pension customer is free to switch fund manager, the choice of influence strategy for AP7 seems to target savings customers and not only the sustainable behaviour of the portfolio firm. We provide practical implications for shareholder engagement by furnishing practitioners in investment management with a new set of tools for choosing influence strategies. Our systematic mapping of influence strategies has practical benefits which can lead to less lengthy and more effective shareholder engagements. We would, at the same time, like to caution the reader that our findings are based on case studies and, hence, a small number of observations which also have a geographic concentration. Hence, some of our findings could be difficult to apply elsewhere. As a final note, our theorizing in this paper has involved, among other things, the link between reputational risk and influence strategies, and we recommend further research in this area as ESG factors are gaining ground in pension fund investment management.

Appendix 1: *Fund-specific overview of AP funds 1–4 (31 Dec. 2009)*

	First AP Fund	Second AP Fund	Third AP Fund	Fourth AP Fund	Seventh AP Fund
Fund capital, 1 Jan. 2001, Euro bn.*	**13.8**	**13.8**	**13.8**	**13.8**	**n/a**
Total asset under management, Euro bn.* (as of 31 Dec. 2009)	**20.8**	**21.0**	**21.2**	**20.11**	**9.22**
Average annual return, 2001–2009 (after expenses)	**3.2%**	**3.3%**	**3.5%**	**n/a**	**n/a**
Five-year return on total portfolio after commission and operation expenses					
2009	**34.6%**	**20.6%**	**29.2%**	**21.5%**	**35.1%**
2008	**-48.0%**	**-24.0%**	**-44.8%**	**-20.8%**	**-36.2%**
2007	**9.7%**	**4.2%**	**10.7%**	**2.5%**	**4.7%**
2006	**18.2%**	**13.0%**	**18.6%**	**10.5%**	**10.5%**
2005	**27.6%**	**18.7%**	**28.8%**	**16.9%**	**25.1%**
Asset class, per cent (as of 31 Dec. 2009)					
Global equities, developed markets	**36%**	**52%**	**49.7%**	**42.5%**	**52%**
Swedish equities	**14%**			**18.0%**	**20%**
Global equities, emerging markets	**8%**			**3%**	**10%**
Fixed income	**34%**	**37%**	**34%**	**35.0%**	**8%**
Alternative investments	**5%**	**11%**	**16.3%**	**3.5%**	**10%**
External management of total portfolio (31 Dec. 2009)	**42.4%**	**24%**	**40.7%**	**21.1%**	**n/a**
Active management of total portfolio (31 Dec. 2007)	**n/a**	**n/a**	**n/a**	**57.7 %**	**n/a**
No. of employees (as of 31 Dec. 2007)	**43**	**31**	**55**	**53**	**18**

Source: Annual Reports 2009, AP1–4 & AP7; *Euro/SEK 9.73 (10 Mar. 2010)

Appendix 2: *Summary of the First–Fourth AP Funds' investment rules*

Type of instrument for permitted investments	*Permitted investments*
General	All instruments in the capital market. Shares and receivables must be admitted to trading on a regulated market.
Unlisted securities	A maximum of five per cent of the fund capital may be invested in shares or receivables in venture capital companies that are not traded on a regulated market. Unlisted shares (property shares excepted) may only be owned indirectly, via a fund or a venture capital company.
Interest-bearing instruments	At least 30 per cent of the fund capital must be invested in low-risk, interest-bearing securities.
Derivatives	They are to be used primarily to enhance management efficiency or reduce risks. They may not have commodities as an underlying asset.
Credits	Bank borrowing and lending on the call loan market. Direct loans to self-owned property companies. Repos and securities borrowing primarily as a means of enhancing management efficiency.
Borrowing	Short-term borrowing to cover temporary needs. There is an option to borrow from the National Debt Office when funds are depleted.
Foreign currency	A maximum of 40 per cent of the capital may be exposed to currency risk.
Major exposures	A maximum of 10 per cent of the fund capital may be exposed to a given enterprise or group of companies that is internally linked.
Swedish shares	The market value of a fund's holdings in Swedish companies may not exceed 2 per cent of the total market value.
Number of votes	A maximum of 10 per cent in individual listed companies (self-owned property companies excempted). A maximum of 30 per cent in unlisted companies.
External management assignments	At least 10 per cent of the investment capital must be managed externally.

(Source: SOU, 2008)

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